United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

MODULAR TECHNICS CORPORATION,

Plaintiff-Appellant,

against

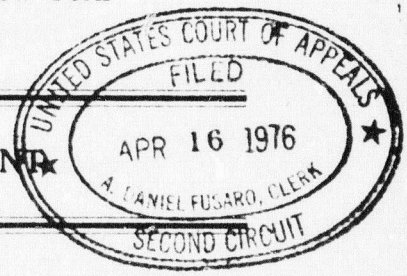
UNITED STATES DEPARTMENT OF HOUSING & URBAN DEVELOPMENT and FEDERAL HOUSING ADMINISTRATION,

Defendants-Appellees,

SOUTH HAVEN HOUSES HOUSING DEVELOPMENT FUND COMPANY, INC., and CHEMICAL BANK,

Defendants.

On Appeal From The United States District Court For The Eastern District of New York



BRIEF OF APPELLANT

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In the

United States Court of Appeals

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Modular Technics Corporation,

Plaintiff-Appellant,

against

United States Department of Housing & Urban Development and Federal Housing Administration,

Defendants-Appellees,

South Haven Houses Housing Development Fund Company, Inc., and Chemical Bank,

Defendants.

On Appeal From the United States District Court for the Eastern District of New York.

BRIEF OF APPELLANT.

Statement of Nature of Case.

This is an appeal from the judgment dated January 22, 1976, of the United States District Court for the Eastern District (Hon. Thomas C. Platt, Justice) dismissing the complaint as to the defendants, United States Department of Housing and Urban Development (HUD) and Federal Housing Administration (FHA).

Defendants HUD and FHA moved to dismiss pursuant to Rule 12(b) of the Federal Rules of Civil Procedure on

the grounds that the suit is barred by the sovereign immunity of the federal defendants.

This action was removed from New York State Courts to the District Court under 28 U.S.C. §1442 (a) (1).

Facts.

Plaintiff has set out in its complaint eleven causes of action and seeks judgment against HUD and FHA on six of them. Two causes of action (numbers 2 and 3) in the complaint claim that plaintiff performed certain work, labor and services and furnished materials at the special instance and request of the defendants and has not received compensation.

The fourth cause of action alleges that FHA represented and warranted that plaintiff could successfully perform its obligations in certain ways; that plaintiff relied on the existence of conditions as warranted; that the conditions were not as warranted, and that, as a result, plaintiff suffered uncompensated losses.

The ninth cause of action claims that FHA acted as an agent or quasi-agent for South Haven; that FHA represented that certain additional compensation would be paid to plaintiff; that these representations induced plaintiff to enter the contract; that FHA knew extra compensation would not be forthcoming; that HUD and FHA caused, by duress, plaintiff to fail to submit applications for extra compensation, and that plaintiff has thereby been damaged.

The tenth cause of action alleges that FHA was a quasi-agent of South Haven; that FHA knew material facts concerning certain expenses; that FHA by non-disclosure of these facts to plaintiff represented the non-existence of these facts; that plaintiff relied on these representations in

deciding to enter the contract, and that plaintiff has been damaged because of the false representations.

The eleventh cause of action alleges that the plaintiff, through its efforts, work performed and materials and services supplied, is the owner and rightfully entitled to certain monies held back and accumulated during the course of construction in the sum of $449,020. At the time the complaint was prepared it was not known who was holding these monies and so the complaint, as drafted, makes claim only against the owner, South Haven Houses Housing Development Fund Co., Inc. (South Haven). However, in fact, upon information and belief, HUD and FHA, subsequent to the preparation of the complaint, have come into possession and/or control of such retainage monies and, in the event of a reversal, the complaint would be amended accordingly.

The defendant, South Haven, entered into a building loan agreement with the defendant Chemical Bank. The loan was to provide mortgage funds for the construction of low-income housing project. The secretary, acting through the Commissioner of the Federal Housing Administration, agreed to insure the building loan agreement under Section 236 of the National Housing Act, 12 U.S.C. Section 1715 Z-L. Chemical Bank agreed to lend South Haven $5,597,000 to be advanced in stages during construction.

Plaintiff executed a contract with South Haven for the general and off-site construction of the project for which South Haven agreed to pay plaintiff the actual cost of construction plus a fee. Changes and extras were required and requested. The cost of improvement was to be paid totally by advances under the building loan agreement and the owner was not required to make any financial investment in the development. Monies were to be advanced

by Chemical Bank to South Haven and progress payments were then to be made to plaintiff pursuant to the building loan agreement.

Plaintiff completed 96% of the work required by the construction contracts and related documents and would have completed 100% but for various breaches and defaults brought about by the action and non-action of the defendants.

Subsequent to the submission of the motion papers in this case, the defendant South Haven defaulted in its payments to the defendant Chemical Bank and the defendant Chemical Bank has assigned the mortgage to the federal defendants.

POINT I.

The activities alleged in the complaint are authorized.

In setting forth the powers of the Secretary of HUD in Chapter 13 of Title 12 of the United States Code, Congress provided that

> "The Secretary shall, in carrying out the provisions of this subchapter and subchapters II, III, V, VI, VII, VIII, X, IX-A, IX-B, of this chapter be authorized in his official capacity, to sue and to be sued in any court of competent jurisdiction, State of Federal." 12 U.S.C. §1702.

Plaintiff, contends that Congress has consented to suit against the Secretary for the activities alleged in the complaint on the theory that the Secretary is an implied party to the transaction between the plaintiff and the sponsor-mortgagor of the project which in turn is

related to "carrying out" the provisions of the aforementioned subchapters.

Among the agreements referred to in paragraphs numbered 6 and 26 of the complaint involving the parties hereto were a mortgage commitment, building loan agreement, mortgage and mortgage note.

The government, while claiming that there was no authority in law for any employee or official of the federal government to enter into the contracts alleged in the complaint, did not on the motion to dismiss raise any question or seek to distinguish between contracts to insure mortgages and contracts to build buildings.

The mortgage between defendants South Haven and Chemical Bank insured by the federal defendants by its terms specifically includes the building loan agreement (Par. 16) and goes on to provide that if construction of the improvements pursuant to such building loan agreement shall not be carried out then the mortgagee may enter upon the premises to preserve and protect the property, and to continue any and all outstanding contracts for the erection and completion of the buildings and to make and enter into contracts and obligations either in its own name or in the name of the mortgagor or other owner, and to pay and discharge all debts and liabilities incurred thereby. Since the insurance provisions of the act provide for the assignment by the bank-mortgagee to the Secretary in the event of default and/or otherwise, and the law provides that as assignee the Secretary steps into the shoes of the bank; *ergo*, the Secretary was and is authorized to enter into and to complete construction contracts.

The District Court, in concluding that the Secretary was immune from suit with respect to the obligations

upon which plaintiff seeks recovery herein, distinguished between mortgage insurance contracts and contracts to construct buildings. In actuality, this is a distinction without a difference, and the court should not have granted the motion to dismiss without having reviewed the mortgage documents and afforded the plaintiff the opportunity to comment thereupon.

It is not inequitable to hold the government *liable* to a party with whom it has not specifically contracted. *Travelers Indemnity Co. v. First National State Bank of New Jersey*, 328 F. Supp. 208; *Sears, Roebuck & Co. v. Jardel Co. Inc.*, 421 F. 2d 1048 (3rd Cir. 1970); *County of Giles v. First U. S. Corp.*, 223 Tenn. 345, 445 S. W. 2d 157 (Tenn. 1969); *Flintkote Co. v. Brewer Co. of Florida, Inc.*, 221 So. 2d 784 (Fla. Ct. App. 1969), cert. denied 225 So. 2d 920 (Fla. 1969); *Thomas G. Snavely Co. v. Brown Construction Co.*, 16 Ohio Misc. 50, 45 Ohio Op. 2d 41, 239 N. E. 2d 759 (C. P. 1968); Comment, *Contracts for the Benefit of Third Parties in the Construction Industry*, 40 Fordham L. Rev. 315 (1971). It is clear that the National Housing Act was meant to benefit more than just mortgagees. Cf. *Caramico v. Secretary of the Department of Housing and Urban Development*, 509 F. 2d 694, 700-701 (2d Cir. 1974). As part of the 1968 amendments to the act, for example, provision was made for the Secretary of HUD to require that opportunities for employment arising in connection with the construction or rehabilitation of housing be given to lower income persons residing in the area of such housing in order to provide jobs as well as housing for these people. House Report, U. S. Code Cong. and Adm. News at 2877. Congress intended the National Housing Act to be effectuated in part through the participation of private enterprise in the financing and production of housing. This intent was carried over in 1968 amendments to the act.

POINT II.

When government enters the marketplace to engage in commercial and business transactions, and permits itself "to sue and be sued," waiver of governmental immunity should not be unduly restricted.

The purpose of the 1968 amendments to the National Housing Act was to create housing for low and moderate income families. House Banking and Currency Committee, Housing and Urban Development Act of 1968, H. R. Rep. No. 1585, 90th Cong., 2d Sess. (1968). However, instead of utilizing the services of the Corps of Engineers, or other similar governmental unit—as in the case, for example, in the dredging harbors—Congress attempted to achieve its goal by a roundabout, fictional method of payments to mortgagees meeting special requirements.

Assistance under the National Housing Act takes the form of periodic payments to a mortgagee on behalf of the mortgagor which thereby reduces interest costs on the mortgage. The mortgagor supposedly makes monthly payments for principal and interest as if the mortgage had an interest rate of one percent, while the federal government pays the difference between the market interest rate and the 1% rate to the mortgagee. FHA mortgage insurance is part of the program.

Under the insurance aspects, the construction lender is protected against all risks of default. The lender may immediately claim from FHA under the mortgage insurance contract if the mortgagor defaults. The lender has the option of either foreclosing or assigning the mortgage to HUD.

The sponsor-mortgagor of the project are individual representatives of a community group, with no assets.

Even seed money is obtained from outside sources, i. e., New York City, New York State. The owner is eligible for loans in the amount of the total cost of development.

The government controls the financial arrangement and takes responsibility for the execution of the project. The Commissioner of the FHA, acting on behalf of the Secretary, maintains control over the payment of advances to the owner and ultimately to the contractor. The borrower is entitled only to such amount "as may be approved by the Lender and the Commissioner" (Building Loan Agreement) and the bank is to continue to advance funds to the borrower only so long as the loan remains in balance and the borrower is not in default.

FHA prepares Project Income Analyses and Appraisals with respect to the project. The Commitment for Insurance of Advances, setting forth the terms of the insurance endorsement by HUD of the mortgage, provides that both the building loan agreement and the construction contract are to be executed on forms provided by HUD. The mortgage, in addition, is executed on an FHA form. The approval by HUD of all work and materials is required in order for the contractor to be paid. These are but a few of the examples of the complete control exercised by the Secretary.

Plaintiff was led to expect that HUD would make good any sums rightfully due the contractor in construction projects involving non-profit organizations. It is significant that although both the bank and HUD and the mortgagor knew that the mortgagor was a non-profit organization with little or no assets they used forms of building loan agreement which were designed to be used by profit making corporations. They consequently each participated in what may be said to be a cosmetic fraud upon the

builder who, upon the strength of those documents, would have in the normal course recourse against a profit making corporation.

The owner, since it was without assets, was in actuality created and permitted to enter into the agreements pursuant to design of the Legislature for the convenience of the government in effectuating the program.

The bank was fully insured in the event of default by the owner. The government had the remedy of foreclosure available to it in the event of default. The only one lacking protection against default is the plaintiff. A court of equity has the inherent power which, in the interest of justice, should be exercised to pierce and surmount obvious fabrications which are created by the government with the assistance of the bank.

> *F. W. Eversley v. The East New York, etc., et al.*, Dist. Ct. So. Dist., Judge Werker (1976).

Since consent "to sue and be sued" has been given by Congress, the problem here merely involves a determination of whether or not the import of the injunction of *FHA v. Burr*, 309 U. S. 242, that waivers of governmental immunity must be liberally construed extends to the activities of the government here involved.

In *Burr* the court said:

> "Rather if the general authority to 'sue and be sued' is to be delimited by implied exceptions, it must be clearly shown that certain types of suits are not consistent with the statutory or constitutional scheme, that an implied restriction of the general authority is necessary to avoid grave interference with the performance of a governmental function, or that for other reasons it was plainly

> the purpose of Congress to use the 'sue and be sued' clause in a narrow sense. In the absence of such showing, it must be presumed that when Congress launched a governmental agency into the commercial world and endowed it with authority to 'sue or be sued,' that agency is not less amenable to judicial process than a private enterprise under like circumstances would be."

Clearly the words "sue and be sued" in their normal connotation embrace the activities of the government here involved.

POINT III.

Suits against governmental agencies are to be distinguished from suits wherein the United States is a party defendant.

Title 28 U. S. C. 1346(a) (2) as amended, otherwise known as the Tucker Act, provides that

> "(a) The district courts shall have original jurisdiction, concurrent with the Court of Claims of
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> * * *
>
> "(2) Any other Civil Action or claim against the United States, not exceeding $10,000. in amount, founded either upon the Constitution or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. For the purpose of this paragraph, an express or implied contract with the Army and Air Force Exchange Service, Navy Exchanges, Marine Corps. Exchanges Coast Guard Exchanges or Exchange Councils of the National Aeronautics and Space Administration shall be considered an express or implied contract with the United States."

Since 1948, the Congress on four (4) occasions, 1964, 1966, 1970 and 1972, has found it desirable and/or necessary to amend the Tucker Act. However, at no time did it deem it desirable or necessary to extend the immunity from suit limitations contained in the Tucker Act beyond that of the United States as a party.

In 1970 the Congress added the latter portion of subsection (a) (2) specifying that the term express or implied contracts with the United States includes express or implied contracts with the Army and Air Force Exchanges, etc. By so doing, it exhibited its awareness of the need to define the person "United States" insofar as this statute was to be applied, and of its legislative intent to exclude governmental agencies and corporations from such definition. *George H. Evans & Co. vs. United States*, 169 F. 2d 500 (3rd Cir. 1948).

In *Ferguson v. Union National Bank of Clarksburg, W. Va.*, 126 F. 2d 753, 756-7 (4th Cir. 1942), the court held:

> "It is specifically provided that the Administrator in his official capacity may 'sue and be sued in any court of competent jurisdiction, State or Federal' 12 U.S.C.A. 1702. It could hardly have been intended by Congress that suits for over $10,000 against the Administrator could be brought in any state court of general jurisdiction, but in the federal jurisdiction only in the Court of Claims; and as we read recent decisions of the Supreme Court the jurisdiction of a U. S. District Court to entertain a suit against governmental agencies and corporations is not limited by the provisions of the Tucker Act." But cf. *Akin Mobile Homes, Inc., v. Sec'y of HUD*, 475 F. 2d 1261 (5th Cir. 1973).

POINT IV.

The government having acquired a housing project 96% complete at a cost less than its actual value has been unjustly enriched at the plaintiff's expense.

Through 12 U. S. C. Section 1715z-3 (a) (2) (1970), the provisions of 12 U. S. C. Section 1713 (g) (1970) apply to Section 236 projects. Under the latter provision, once default has occurred and the mortgage has been assigned, any balance of the mortgage loan not advanced by the mortgagee is assigned to the Secretary along with any property held by the mortgagee as deposits made for the account of the mortgagor. Thus, the government is now in possession of any funds to which plaintiff is now entitled in light of the fact that the mortgage was assigned.

The escrow funds and retainages constitute an identifiable *res* held by the government and Chemical Bank upon which an equitable lien may be placed. *American Fidelity Fire Insurance Co. v. Construcciones Werl, Inc.*, Civ. No. 576/1973 (D.V.I., filed Nov. 26, 1975). Upon the making of each payment of the building loan proceeds it was required that the HUD approve the payment after inspection. Thus HUD certified that the full amount of the progress installment was due. The amount held back was held for two reasons: first, to stimulate completion of the construction according to the timetable, and second, to insure that a fund would be available, to complete the project if the contractor defaulted in part. Thus, an identifiable fund was created. As in *American Fidelity*, the funds were ultimately designated for payment to the general contractor for completion of the project under the construction contract. As that court stated:

> "The legal obligations are not set aside; they are *surmounted* and transcended by equitable considera-

> tions." *American Fidelity, supra,* Slip. op. at 27. (Emphasis in the original.)

In *G. L. Wilson Building Co. v. Leatherwood,* 268 F. Supp. 609 (W.D.N.C. 1967), a general contractor had contracted to construct a furniture plant for a private owner, to be financed by the Area Redevelopment Administration and the Small Business Administration. During the course of construction, the owner experienced financial difficulties which ultimately resulted in a default on the loan and a foreclosure by the Small Business Administration, after construction had been completed. A receiver was appointed for the owner and all the owner's assets were distributed. The only recourse that the general contractor had was to the Small Business Administration.

The court found that conventional remedies would be of no assistance to the general contractor but held that it had power as a court of equity to grant the contractor recovery under the doctrine of equitable lien. The court stated:

> "Of course it is generally known that no identic form or phraseology is necessary to create an equitable lien for that a court of equity always looks through the form to the substance of the transaction, *and it would appear beyond question that the facts and circumstances of this case represent an area where equity should act under the doctrine of an equitable lien,* thereby recognizing the right of plaintiff to have the specific funds herein applied to the obligations that arise from the work done and the materials furnished." 26 F. Supp. at 621. (Emphasis added.)

Similarly, in *Henningsen v. United States Fidelity & Guaranty Co.,* 208 U. S. 404, 410 (1908), the Supreme Court stated that in a construction contract under which the fed-

eral government controlled the retentions, the *government* had "equitable obligations to see that laborers and supplyment were paid."

The application of the equitable lien theory, in order to prevent unjust enrichment, was most clearly presented in *Swinerton v. Walberg Co. v. Union Bank,* 25 Cal. App. 3d 259, 101 Cal. Rptr. 665, 54 A.L.R. 3d 839 (Dist. Ct. App. 1972). There, an action was brought to impose an equitable lien, in favor of a general contractor, on funds held by a lender in a construction loan disbursement account. The loan agreement provided for payment during the course of construction with provisions for a 10% retainage to be held pending completion. The agreement provided further that, if the owner defaulted on obligations to the lender, construction funds could be applied against the obligations.

After completion of the project, the owner defaulted on its obligations to the lender and subsequently the lender foreclosed. The lender did not, however, seek to apply undisbursed construction funds to the owner's obligation to it and there remained considerable undisbursed funds in the construction loan account. The trial court found that the contractor was induced to construct the apartment building by the owner and the lender; that it relied on the construction loan disbursement fund for payment; that it completed its contract; that the value of construction exceeded the agreed upon cost of construction, and that the lender had no reason to refuse to disburse the retained percentage. In so holding, the trial court held that the contractor was entitled to the retained funds from the bank.

In affirming the decision of the trial court, the Court of Appeals held that the contractor maintained an equitable

lien in the retained funds and cited the language of an earlier California case:

> "Where the lender has received the benefit of the claimant's performance, and therefore a more valuable security for its note, it is not justified in withholding or appropriating to any other use money originally intended to be used to pay for such performance and relied upon by the claimant in rendering its performance."

In *Swinerton,* the court found that the contractor performed its work and completed construction of the building, but received far less than the reasonable value of the work performed. Accordingly, the bank, through foreclosure, obtained the benefit of the contractor's performance without paying for that performance. The court noted:

> "It is equally clear that [the contractor] was induced by the creation of the building construction loan fund to supply work, labor and materials for the project and that in rendering its performance it relied on the fund for payment. Indeed, since [the lender] had acquired a first lien on the property to protect its construction loan, [the contractor] could look to little else for security."

In addition to plaintiff's entitlement to hold-backs on the basis of an equitable lien, recovery of those funds is warranted as a third-party beneficiary of the Building Loan Agreements.

> *Travelers Indemnity Co. v. First National State Bank of New Jersey,* 328 F. Supp. 208 (D. N. J. 1971);
>
> *B. B. Adams General Contractor Inc. v. Department of Housing and Urban Development,* Civ. Action 3-6168 (N.D. Tex.), order of May 18, 1973, appeal dismissed 501 F. 2d 176 (5th Cir. 1974).

In *Travelers*, the mortgagee assigned the mortgage to the Secretary and transferred with it, pursuant to 12 U. S. C. §1713 (g) (4) (5), the balance of the undisbursed mortgage fund. Suit was instituted directly against the Secretary by the co-trustees in bankruptcy of the contractor and the surety company that issued a dual obligee bond on behalf of the contractor. At issue was the entitlement of plaintiffs, as third-party beneficiaries, to the undisbursed mortgage funds.

Recognizing the existence of an identifiable fund for the payment of laborers and materialmen, the court looked to the National Housing Act and the regulations of the Department of Housing and Urban Development:

> "The various pertinent statutes, regulations and agreements set up an elaborate system enabling the mortgagee to retain a portion of the funds payable under the building and loan agreement to insure the mortgagor's performance of his obligation to erect the project; upon completion of the project the disposal of the funds is also provided for. These various statutes and regulations and the building loan agreement are incorporated into the mortgage; accordingly when the mortgage was assigned so were the rights and duties arising under it as well as those arising under incorporated agreements" (238 F. Supp. at 211).

Having acknowledged the existence of funds retained by the mortgagee during the course of construction, and the obligation to disburse those funds at the conclusion of the project (whether the funds remain in possession of the mortgagee or are transferred to the Secretary pursuant to an assignment), the court also acknowledged that the contractors are entitled to those funds as third-party beneficiaries. This finding is merely a restatement of well-settled principles of law which entitle persons other than

direct parties to the contract to recover on the contract, or on a surety bond, where those persons seeking relief are the intended beneficiaries of the contract (*German Alliance Insurance Co. v. Home Water Supply Co.*, 226 U. S. 220, 230; *Robbins Drydock & Repair Co. v. Flint*, 275 U. S. 303, 307; *United States ex rel. Johnson v. Morely Construction Co.*, 98 F. 2d 781, 789 (2d Cir. 1938); *Pearlman v. Reliance Insurance Company*, 371 U. S. 132, 138 (1962); *U. S. v. James Baird Co.*, 73 F. 2d 652 (D.D.C. 1934).

Thus, the court in *Travelers* stated: "This court deems the plaintiffs to be creditor third-party beneficiaries of the building loan agreement, and the secretary to be the assignee of said agreement" (328 F. Supp. 211). The court arrived at this by an analysis of the building loan agreement and mortgage documents, which are essentially the same as those before this court.

POINT V.

The agencies named are proper parties.

There was some reference made in the District Court decision of the fact that suit was brought against the Department of Housing and Urban Development and Federal Housing Administration rather than against the Secretary.

When the statute authorized suits by or against the Secretary "in his official capacity" it permitted actions by or against the agency for which he is the administrator.

As administrator he acts for and on behalf of the agencies since by express terms of the act all of the powers of the latter shall be exercised by him. Hence action by

him in the name of the agency would be action in his official capacity. *FHA v. Burr,* 309 U. S. 242. *A fortiori* the reverse must also be true.

CONCLUSION.

Plaintiff should be afforded its day in court. Judgment dismissing complaint should be reversed.

Respectfully submitted,

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Attorney for